Financial Crisis: Asset Securitization- The Last Tango

Endgame: Unregulated Private Money Creation

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The Financial Tsunami, Part IV.

Endgame: Unregulated Private Money Creation

What had emerged going into the new millennium after the 1999 repeal of Glass-Steagall was an awesome transformation of American credit markets into what was soon to become the world's greatest unregulated private money creation machine.

The New Finance was built on an incestuous, interlocking, if informal, cartel of players, all reading from the script written by Alan Greenspan and his friends at J.P. Morgan, Citigroup, Goldman Sachs, and the other major financial houses of New York. Securitization was going to secure a "new" American Century and its financial domination, as its creators clearly believed on the eve of the millennium.

Key to the revolution in finance in addition to the unabashed backing of the Greenspan Fed, was the complicity of the Executive, Legislative and Judicial branches of the US Government right to the Supreme Court. In addition, to make the game work seamlessly, it required the active complicity of the two leading credit agencies in the world—Moody's and Standard & Poors.

It required a Congress and Executive branch that would repeatedly reject rational appeals to regulate over-the-counter financial derivatives, bank-owned or financed hedge funds or any of the myriad steps to remove supervision, control, transparency that had been painstakingly built up over the previous century or more. It required that the major government-certified rating agencies give their credit AAA imprimatur to a tiny handful of poorly regulated insurance companies called Monolines, all based in New York. The monolines were another essential part of the New Finance.

The interlinks and consensus behind the massive expansion of securitization among all these institutional players was so clear and pervasive it might have been incorporated as America New Finance Inc. and its shares sold over NASDAQ.

Alan Greenspan anticipated and encouraged the process of asset securitization for years before his actual nurturing of the phenomenal real estate bubble in the beginning of the first decade of the new Century. In a pathetic attempt to deny his central role after the fall, Greenspan last year claimed that the problem was not mortgage lending to sub-prime customers but the securitization of the sub-prime credits. In April 2005, he sung a quite different hymn to sub-prime securitization. Addressing the Federal Reserve System's Fourth Annual Community Affairs Research Conference, the Fed chairman declared,

> "Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants. Such developments are representative of the market responses that have driven the financial services industry throughout the history of our country. With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers…**The mortgage-backed security helped create a national and even an international market for mortgages, and market support for a wider variety of home mortgage loan products became commonplace**. This led to securitization of a variety of other consumer loan products, such as auto and credit card loans."

That 2005 speech was about the time he later claimed to have suddenly realized securitization was getting out of hand. In September 2007 once the crisis was full force, CBS' Leslie Stahl asked why he did nothing to stop "illegal or shady practices you knew were taking place in sub-prime lending." Greenspan replied, "Err, I had no notion of how significant these practices had become until very late. **I didn't really get it** until late 2005 and 2006." (emphasis added-w.e.)

As far back as November 1998, only weeks after the near-meltdown of the global financial system through the collapse of the LTCM hedge fund, Greenspan had told an annual meeting of the US Securities Industry Association, "Dramatic advances in computer and telecommunications technologies in recent years have enabled a broad unbundling of risks through innovative financial engineering. The **financial instruments of a bygone era, common stocks and debt obligations, have been augmented by a vast array of complex hybrid financial products, which allow risks to be isolated, but which, in many cases, seemingly challenge human understanding."**

That speech was the clear signal to Wall Street to move into asset-backed securitization in a big way. After all, hadn't Greenspan just demonstrated through the harrowing Asia crises of 1997-98 and the systemic crisis triggered by the August 1998 sovereign debt default that the Federal Reserve and its liquidity spigot stood more than ready to bailout the banks in event of any major mishap? The big banks were, after all, clearly now, Too Big To Fail—TBTF.

The Federal Reserve, the world's largest and most powerful central bank with what was arguably the world's most liberal market-friendly Chairman, Greenspan, would back its major banks in the bold new securitization undertaking. When Greenspan said risks "which seemingly challenge human understanding," he signaled that he understood at least in a crude way that this was a whole new domain of financial obfuscation and complication. Central bankers traditionally were known for their pursuit of transparency among banks and conservative lending and risk management practices by member banks.

Not 'ole Alan Greenspan.

Most significantly, Greenspan reassured his Wall Street securities underwriting friends in the Securities Industry Association audience that November of 1998 that he would do all possible to ensure that in the New Finance, the securitization of assets would remain for the banks alone to self-regulate.

Under the Greenspan Fed, the foxes would be trusted to guard the henhouse. He stated:

> "The consequence (of the banks' innovative financial engineering-w.e.) doubtless has been a far more efficient financial system…The **new international financial system that has evolved** as a consequence has been, despite recent setbacks, a major factor in the marked increase in living standards for those economies that have chosen to participate in it.
>
> It is important to remember–when we contemplate the regulatory interface with the new international financial system–the system that is relevant is not solely the one we confront today. There is no evidence of which I am aware that suggests that the transition to the new advanced technology-based international financial system is now complete. Doubtless, tomorrow's complexities will dwarf even today's.
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> It is, thus, all the more important to recognize that **twenty-first century financial regulation is going to increasingly have to rely on private counterparty surveillance to achieve safety** and soundness. There **is no credible way to envision most government financial regulation being other than oversight of process. As the complexity of financial intermediation on a worldwide scale continues to increase, the conventional regulatory examination process will become progressively obsolescent–at least for the more complex banking systems**. (emphasis added-w.e.)

One might naively ask, why then surrender all those powers like Glass-Steagall to the private banks far beyond possible official regulatory purview?

Again in October 1999, amid the frenzy of the dot.com IT stock market bubble mania, a bubble which Greenspan repeatedly and stubbornly insisted he could not confirm as a bubble, he once again praised the role of financial derivatives and "new financial instruments…reallocating risk in a manner that makes risk more tolerable. Insurance, of course, is the purest form of this service. All the new financial products that have been created in recent years, financial derivatives being in the forefront, contribute economic value by unbundling risks and reallocating them in a highly calibrated manner. He was speaking of securitization on the eve of the all-but certain repeal of the Glass-Steagall Act.

The Fed's "private counterparty surveillance" brought the entire international inter-bank trading system to a screeching halt in August 2007, as panic spread over the value of the trillions of dollars in securitized Asset Backed Commercial Paper and in fact most securitized bonds. The effects of the shock have only begun, as banks and investors slash values across the US and international financial system. But that's getting ahead of our story.

Deregulation, TBTF and Gigantomania among banks

In the United States, between 1980 and 1994 more than 1,600 banks insured by the Federal

Deposit Insurance Corporation (FDIC) were closed or received FDIC financial assistance. That was far more than in any other period since the advent of federal deposit insurance in the 1930s. It was part of a process of concentration into giant banking groups that would go into the next century.

In 1984 the largest bank insolvency in US history threatened, the failure of Chicago's Continental Illinois National Bank, the nation's seventh largest, and one of the world's largest banks. To prevent that large failure, the Government through the Federal Deposit Insurance Corporation stepped in to bailout Continental Illinois by announcing 100% deposit guarantee instead of the limited guarantee FDIC insurance provided. This came to be called the doctrine of "Too Big to Fail" (TBTF). The argument was that certain very large banks, because they were so large, must not be allowed to fail for fear of the chain-reaction consequences it would have across the economy. It didn't take long before the large banks realized that the bigger they became through mergers and takeovers, the more sure they were to qualify for TBTF treatment. So-called "Moral Hazard" was becoming a prime feature of US big banks.

That TBTF doctrine was to be extended during Greenspan's Fed tenure to cover very large hedge funds (LTCM), very large stock markets (NYSE) and virtually every large financial entity in which the US had a strategic stake. Its consequences were to be devastating. Few outside the elite insider circles of the very large institutions of the financial community even realized the doctrine had been established.

Once the TBTF principle was made clear, the biggest banks scrambled to get even bigger. The traditional separation of banking into local S&L mortgage lenders, large international money center banks like Citibank or J.P. Morgan or Bank of America, the prohibition on banking in more than one state, one by one were dismantled. It was a sort of "level playing field" but level for the biggest banks to bulldoze over and swallow up the smaller and create cartels of finance of unprecedented scope.

By 1996 the number of independent banks had shrunk by more than one-third from the late 1970s, from more than 12,000 to fewer than 8,000. The percentage of banking assets controlled by banks with more than $100 billion doubled to one-fifth of all US banking assets. The trend was just beginning. The banks' consolidation was a direct outgrowth of the removal of geographic restrictions on bank branching and holding company acquisitions by the individual states, formalized in the 1994 Interstate Banking and Branch Efficiency Act. Under the rubric of "more efficient banking" a Darwinian survival of the biggest ensued. They were by no means the fittest. The consolidation was to have significant consequences a decade or so later as securitization exploded in scale beyond the banks' wildest imagination.

J.P.Morgan blazes the trail

In 1995, well into the Clinton-Rubin era, Alan Greenspan's former bank, J.P. Morgan, introduced an innovation that was to revolutionize banking over the next decade. Blythe Masters, a 34-year old Cambridge University graduate hired by the bank, developed the first Credit Default Swaps, a financial derivative instrument that ostensibly let a bank insure against loan default; and Collateralized Debt Obligations, bonds issued against a mixed pool of assets, a kind of credit derivative giving exposure to a large number of companies in a single instrument.

Their attraction was that it was all off the bank's own books, hence away from the Basle Accord's 8% capital rules. The goal was to increase bank returns while eliminating the risk, a kind of "having your cake and eating it too," something which in the real world can only be very messy.

J.P.Morgan thereby paved the way to transform US banking away from traditional commercial lenders to traders of credit, in effect, into securitizers. The new idea was to enable the banks to shift risks off their balance sheets by pooling their loans and remarketing them as securities, while buying default insurance, Credit Default Swaps, after syndicating the loans for their clients. It was to prove a staggering development, soon to hit volumes measured in the trillions for the banks. By the end of 2007 there were an estimated $45,000 billion worth of Credit Default Swap contracts out there, giving bondholders the illusion of security. That illusion, however, was built on bank risk models of default assumptions which are not public and, if like other such risk models, were wildly optimistic. Yet the mere existence of the illusion was sufficient to lead the major banks of the world, lemming-like, into buying mortgage bonds collateralized or backed by streams of mortgage payments from unknown credit quality, and to accept at face value a Moody's or Standard & Poors AAA rating.

Just as Greenspan as new Fed chairman turned to his old cronies at J.P. Morgan when he wanted to grant a loophole to the strict Glass-Steagall Act in 1987, and as he turned to J.P. Morgan to covertly work with the Fed to buy derivatives on the Chicago MMI stock index to artificially manipulate a recovery from the October 1987 crash, so the Greenspan Fed worked with J.P. Morgan and a handful of other trusted friends on Wall Street to support the launch of securitization in the 1990's, as it became clear what the staggering potentials were for the banks who were first and who could shape the rules of the new game, the New Finance.

It was J.P. Morgan & Co. that led the march of the big money center banks beginning 1995 away from traditional customer bank lending towards the pure trading of credit and of credit risk. The goal was to amass huge fortunes for the bank's balance sheet without having to carry the risk on the bank's books, an open invitation to greed, fraud and ultimate financial disaster. Almost every major bank in the world, from Deutsche Bank to UBS to Barclays to Royal Bank of Scotland to Societe Generale soon followed like eager blind lemmings.

None however came close to the handful of US banks which came to create and dominate the new world of securitization after 1995, as well as of derivatives issuance. The banks, led by J.P. Morgan, first began to shift credit risk off the bank balance sheets by pooling credits and remarketing portfolios, buying default protection after syndicating loans for clients. The era of New Finance had begun. Like every major "innovation" in finance, it began slowly.

Very soon after, the new securitizing banks such as J.P. Morgan began to create portfolios of debt securities, then to package and sell off tranches based on default probabilities. "Slice and dice" was the name of the new game, to generate revenue for the issuing underwriting bank, and to give "customized risk to return" results for investors. Soon Asset Backed Securities, Collateralized Debt Securities, even emerging market debt were being bundled and sold off in tranches.

On November 2, 1999, only ten days before Bill Clinton signed the Act repealing Glass-Steagall, thereby opening the doors for money center banks to acquire brokerage business, investment banks, insurance companies and a variety of other financial institutions without restriction, Alan Greenspan turned his attention to encouraging the process of bank securitization of home mortgages.

In an address to America's Community Bankers, a regional banking organization, at a conference on mortgage markets, the Fed chairman stated:

> The recent rise in the homeownership rate to over 67 percent in the third quarter of this year owes, in part, to the healthy economic expansion with its robust job growth. But part of the gains have also come about because innovative lenders, like you, have created a far broader spectrum of mortgage products and have increased the efficiency of loan originations and underwriting. Ongoing progress in streamlining the loan application and origination process and in tailoring mortgages to individual homebuyers is needed to continue these gains in homeownership…Community banking epitomizes the flexibility and resourcefulness required to adjust to, and exploit, demographic changes and technological breakthroughs, and **to create new forms of mortgage finance that promote homeownership. As for the Federal Reserve, we are striving to assist you by providing a stable platform for business generally and for housing and mortgage activity.** (emphasis mine—w.e.)

Already on March 8 of that same year, 1999, Greenspan addressed the Mortgage Bankers' Association where he strongly pushed real estate mortgage backed securitization as the wave of the future. He told the bankers there,

> "Greater stability in the supply of mortgage credit has been accompanied by **the unbundling of the various aspects of the mortgage process**. Some institutions act as mortgage bankers, screening applicants and originating loans. Other parties service mortgage loans, a function for which efficiencies seem to be gained by large-scale operations. Still others, mostly with stable funding bases, provide the permanent financing of mortgages through participation in mortgage pools. Beyond this, some others slice cash flows from mortgage pools into special tranches that appeal to a wider group of investors. **In the process, mortgage-backed securities outstanding have grown to a staggering $2.4 trillion…, automated underwriting software is being increasingly employed to process a rapidly rising share of mortgage applications**. Not only does this technology reduce the time it takes to approve a mortgage application, it also offers a consistent way of evaluating applications across a number of different attributes, and helps to ensure that the down-payment and income requirements and interest rates charged more accurately reflect credit risks. These developments enabled the industry to handle the extraordinary volume of mortgages last year with ease, especially compared to the strains that had been experienced during refinancing waves in the past. One key **benefit of the new technology has been an increased ability to manage risk** (sic). Looking forward**, the increased use of automated underwriting and credit scoring creates the potential for low-cost, customized mortgages with risk-adjusted pricing**. By tailoring mortgages to the needs of individual borrowers, the mortgage banking industry of tomorrow will be better positioned to serve all corners of the diverse mortgage market. (emphasis mine-w-e-)."

But only after the Fed punctured the dot.com stock bubble in 2000 and after the Greenspan Fed dropped Fed funds interest rates drastically to lows not seen on such a scale since the 1930's Great Depression, did asset securitization literally explode into a multi-trillion dollar enterprise.

Securitization—the Un-Real Deal

Because the very subject of securitization was embedded with such complexity no one, not even its creators fully understood the diffusion of risk, let alone the simultaneous concentration of systemic risk.

Securitization was a process in which assets were acquired by some entity, sometimes called a Special Purpose Vehicle (SPV) or Special Investment Vehicle (SIV).

At the SIV the diverse home mortgages, let's say, were assembled into pools or bundles as they were termed. A specific pool, say, of home mortgage receivables, now took life in the new form of a bond, an asset backed bond, in this case a mortgage backed security. The securitized bond was backed by the cash flow or value of the underlying assets.

That little step involved a complex leap of faith to grasp. It was based on illusory collateral backing whose real worth, as is now dramatically clear to all banks everywhere, was unknown and unknowable. Already at this stage of the process the legal title to the home mortgage of a specific home in the pool is legally ambiguous, as I pointed out in Part I. Who in the chain actually has in his or her physical possession the real, "wet signature" mortgage deed to the hundreds and thousands of homes in collateral? Now lawyers will have a field day for years to come sorting out Wall Street's brilliant opacities.

Securitization usually applied to assets that were illiquid, that is ones that were not easily sold, hence it became common in real estate. And US real estate today is one of the world's most illiquid markets. Everyone wants out and few want in, at least not at these prices.

Securitization was applied to pools of leased property, to residential mortgages, home equity loans, on student loans, credit card or other debts. In theory all assets could be securitized as long as they were associated with a steady and predictable cash flow. That was the theory. In practice, it allowed US banks to skirt tougher new Basle Capital Adequacy Rules, Basle II, designed explicitly in part to close the loophole in Basle I that let US and other banks shove loans wholesale into off-the-books special entities called Special Investment Vehicles or SIVs.

Financial Alchemy: Where the fly hits the soup

Securitization, thus, converted illiquid assets into liquid assets. It did this, in theory, by pooling, underwriting and selling the ownership claims to the payment flows, as asset-backed securities (ABS). Mortgage-backed securities were one form of ABS, the largest by far since 2001.

Here's where the fly hit the soup.

With the US housing market beginning back in 2006 in sharp downturn and rates on Adjustable Rate Mortgages (ARMs) moving sharply higher across the United States, hundreds of thousands of homeowners were being forced to simply “walk away” from their now un-payable mortgages, or be foreclosed on by one or another party in the complex securitization chain, very often illegally, as an Ohio judge recently ruled. Home foreclosures for 2007 were 75% higher than in 2006 and the process is just beginning, in what will be a real estate disaster to rival or likely exceed that of the Great Depression. In California foreclosures were up an eye-popping 421% over the year before.

That growing process of mortgage defaults in turn left gaping holes in the underlying cash payment stream intended to back up the newly issued Mortgage Backed Securities. Because the entire system was totally opaque, no one, least of all the banks holding this paper, knew what was really the case, what asset backed security was good, or what bad. As nature abhors a vacuum, bankers and investors, especially global investors, abhor uncertainty in financial assets they hold. They treat it like toxic waste.

The architects of this New Finance, based on the securitization of home mortgages, however, found that bundling hundreds of disparate mortgages of varying credit quality from across the USA into a big MBS bond wasn’t enough. If the Wall Street MBS underwriters were to be able to sell their new MBS bonds to the well-endowed pension funds of the world, they needed some extra juice. Most pension funds are restricted to buying only bonds rated AAA, highest quality.

But how could a rating agency rate a bond which was composed of a putative spream of mortgage payments from 1,000 different home mortgages across the USA? They couldn’t send an examiner into every city to look at the home and interview its occupant. Who could stand behind the bond? Not the mortgage issuing bank. They sold the mortgage immediately, at a discount, to get it off their books. Not the Special Purpose Vehicle, they were just there to keep the transactions separate from the mortgage underwriting bank.No something else was needed. Deux Maxima! in stepped the dauntless Big Three (actually Big Two) Credit Raters, the rating agencies.

The ABS Rating Game

Never ones to despair when confronted by new obstacles, clever minds at J.P. Morgan, Morgan Stanley, Goldman Sachs, Citigroup, Merrill Lynch, Bear Stearns and a myriad of others in the game of securitizing the exploding volumes of home mortgages after 2002, turned to the Big Three rating agencies to get their prized AAA. This was necessary because, unlike issuance of a traditional corporate bond, say by GE or Ford, where a known, physical bricks ‘n mortar blue-chip company with a long-term credit history stood behind the bond, with Asset Backed Securities no corporation stood behind an ABS. Just a lot of promises on mortgage contracts across America.

The ABS or bond was, if you will, a “stand alone” artificial creation, whose legality under US law has been called into question. That meant a rating by a credit rating agency was essential to make the bond credible, or at least give it the “appearance of credibility,” as we now realize from the unraveling of the present securitization debacle.

At the very heart of the new financial architecture that was facilitated by the Greenspan Fed and successive US Administrations over the past two decades and more, was a semi-monopoly held by three de facto unregulated private companies who operated to provide credit ratings for all securitized assets, of course for very nice fees.

Three rating agencies dominated the global business of credit ratings, the largest in the world being Moody's Investors Service. In the boom years of securitization, Moody's regularly reported well over a 50% profit on gross rating revenues. The other two in the global rating cartel were Standard & Poor's and Fitch Ratings. All three were American companies intimately tied into the financial sinews of Wall Street and US finance. The fact that the world's rating business was a de facto US monopoly was no accident. It was planned that way, as a main pillar of the financial domination of New York. The control of the credit rating world was for the US global power projection almost tantamount to US domination in nuclear weapons as a power factor.

Former Secretary of Labor, economist Robert Reich, identified a core issue of the raters, their built-in conflict of interest. Reich noted, "Credit-rating agencies are paid by the same institutions that package and sell the securities the agencies are rating. If an investment bank doesn't like the rating, it doesn't have to pay for it. And even if it likes the rating, it pays only after the security is sold. Get it? It's as if movie studios hired film critics to review their movies, and paid them only if the reviews were positive enough to get lots of people to see the movie."

Reich went on, "Until the collapse, the result was great for credit-rating agencies. Profits at Moody's more than doubled between 2002 and 2006. And it was a great ride for the issuers of mortgage-backed securities. Demand soared because the high ratings had expanded the market. Traders didn't examine anything except the ratings…a multibillion-dollar game of musical chairs. And then the music stopped."

That put three global rating agencies—Moody's, S&P, and Fitch—directly under the investigative spotlight. They were de facto the only ones in the business of rating the collateralized securities—Collateralized Mortgage Obligations, Collateralized Debt Obligations, Student Loan-backed Securities, Lottery Winning-backed Securities and a myriad of others—for Wall Street and other banks.

According to an industry publication, *Inside Mortgage Finance*, some 25% of the $900 billion in sub-prime mortgages issued over the past two years were given top AAA marks by the rating agencies. That comes to more than $220 billion of sub-prime mortgage securities carrying the highest AAA rating by either Moody's, Fitch or Standard & Poors. That is now coming unwound as home mortgage defaults snowball across the land.

Here the scene got ugly. Their model assumptions on which they gave their desired AAA seal of approval was a proprietary secret. "Trust us."

According to an economist working within the US rating business, who had access to the actual model assumptions used by Moody's, S&P and Fitch to determine whether a mortgage pool with sub-prime mortgages got a AAA or not, they used historical default rates from a period of the lowest interest rates since the Great Depression, in other words a period with abnormally low default rates, to declare by extrapolation that the sub-prime paper was and would be into the distant future of AAA quality.

The risk of default on even a sub-prime mortgage, so went the argument, "was historically almost infinitesimal." That AAA rating from Moody's in turn allowed the Wall Street investment houses to sell the CMOs to pension funds, or just about anybody seeking "yield enhancement" but with no risk. That was the theory.

As Oliver von Schweinitz pointed out in a very timely book, *Rating Agencies: Their Business, Regulation and Liability*, "Securitizations without ratings are unthinkable." And because of the special nature of asset backed securitizations of mortgage loans, von Schweinitz points out, those ABS, "although being standardized, are one-time events, whereas other issuances (corporate bonds, government bonds) generally affect repeat players. Repeat players have less incentive to cheat than 'one time issuers.'"

Put the other way, there is more incentive to cheat, to commit fraud with asset backed securities than with traditional bond issuance, a lot more.

Moody's, S&P's unique status

The top three rating agencies under US law enjoy an almost unique status. They are recognized by the Government's Securities and Exchange Commission (SEC) as Nationally Recognized Statistical Rating Organizations (NRSROs). There exist only four in the USA today. The fourth, a far smaller Canadian rater, is Dominion Bond Rating Service Ltd. Essentially, the top three hold a quasi monopoly on the credit rating business, and that, worldwide.

The only US law regulating rating agencies, the Credit Agency Reform Act of 2006 is a toothless law, passed in the wake of the Enron collapse. Four days before the collapse of Enron, the rating agencies gave Enron an "investment grade" rating, and a shocked public called for some scrutiny of the raters. The effect of the Credit Agency Reform Act of 2006 was null on the de facto rating monopoly of S&P, Moody's and Fitch.

The European Union, also reacting to Enron and to the similar fraud of the Italian company Parmalat, called for an investigation of whether the US rating agencies rating Parmalat has conflicts of interest, how transparent their methodologies were (not at all) and the lack of competition.

After several years of "study" and presumably a lot of behind-the-scenes from big EU banks involved in the securitization game, the EU Commission announced in 2006 it would only "continue scrutiny" (sic) of the rating agencies. Moody's and S&P and Fitch dominate EU ratings as well. There are no competitors.

It's a free country, ain't it?

The raters under US law were not liable for their ratings despite the fact that investors worldwide depend often exclusively on the AAA or other rating by Moody's or S&P as validation of creditworthiness, most especially in securitized assets. The Credit Agency Reform Act of 2006 in no way dealt with liability of the rating agencies. It was in this regard a worthless paper. It was the only law dealing with the raters at all.

As von Schweinitz pointed out, "Rule 10b-5 of the Securities and Exchange Act of 1934 is probably the most important basis for suing on the grounds of capital market fraud." That rule stated "It shall be unlawful for any person…to make any untrue statement of a material fact." That sounded like something concrete. But then the Supreme Court affirmed in a 2005 ruling, Dura Pharmaceuticals, ratings are not "statements of a material fact" as required under Rule 10b-5. The ratings given by Moody's or S&P or Fitch are rather, "merely an opinion." They are thereby protected as "privileged free speech," under the US Constitution's First Amendment.

Moody's or S&P could say any damn thing about Enron or Parmalat or sub-prime securities it wanted to. It's a free country ain't it? Doesn't everyone have a right to their opinion?

US courts have ruled in ruling after ruling that financial markets are "efficient" and hence, markets will detect any fraud in a company or security and price it accordingly…eventually. No need to worry about the raters then…

That was the "self-regulation" that Alan Greenspan apparently had in mind when he repeatedly intervened to oppose any regulation of the emerging asset securitization revolution.

The securitization revolution was all underwritten by a kind of "hear no evil, see no evil" US government policy that said, what is "good for the Money Trust is good for the nation." It was a perverse twist on the already perverse saying from the 1950's of then General Motors chief, Charles E. Wilson, "what's good for General Motors is good for America."

Monoline insurance: Viagra for securitization?

For those CMO sub-prime securities that fell short of AAA quality,there was also another crucial fix needed. The minds on Wall Street came up with an ingenious solution.

The issuer of the Mortgage Backed Security could take out what was known as Monoline insurance. Monoline insurance for guaranteeing against default in asset backed securities was another spin-off of the Greenspan securitization revolution.

Although monoline insurance had begun back in the early 1970's as a guarantee for municipal bonds, it was the Greenspan securitization revolution which gave it its leap into prominence.

As their industry association stated, "The monoline structure ensures that our full attention is given to adding value to our capital market customers." Add value they definitely did. As of December 2007, it was reliably estimated that the monoline insurers, who call themselves "financial guarantors," eleven poorly capitalized, loosely regulated monoline insurers, all based in New York and regulated by that state's insurance regulator, had given their insurance guarantee to enable the AAA rated securitization of over ***$2.4 trillion worth of Asset Backed Securities*****. (emphasis mine—f.w.e.).**

Monoline insurance became a very essential element in the fraud-ridden Wall Street scam known as securitization. By paying a certain fee, a specialized (hence the term monoline) insurance company would insure or guarantee a pool of sub-prime mortgages in event of an economic downturn or recession in which the poor sub-prime homeowner could not service his monthly mortgage payments.

To quote from the official website of the monoline trade association, “The Association of Financial Guaranty Insurers, AFGI, is the trade association of the insurers and re-insurers of municipal bonds and asset-backed securities. A bond or other security insured by an AFGI member has the unconditional and irrevocable guarantee that interest and principal will be paid on time and in full in the event of a default.” Now they regret ever having promised that as sub-prime mortgage resets, growing recession and mortgage defaults are presenting hyperbolic insurance demands on the tiny, poorly capitalized monolines.

The main monoline insurers were hardly household names: ACA Financial Guaranty Corp., Ambac Assurance, Assured Guaranty Corp. BluePoint Re Limited, CIFG, Financial Guaranty Insurance Company, Financial Security Assurance, MBIA Insurance Corporation, PMI Guaranty Co., Radian Asset Assurance Inc., RAM Reinsurance Company and XL Capital Assurance.

A cautious reader might ask the question, “Who insures these eleven monoline insurers who have guaranteed billions indeed trillions in payment flows over the past five or so years of the ABS financial revolution?”

No one, yet, was the short answer. They state, “Eight AFGI member firms carry a Triple-A claims paying ability rating and two member firms carry a Double-A claims paying ability rating.” Moody’s, Standard & Poors and Fitch gave the AAA or AA ratings.

By having a guarantee from a bond insurer with an AAA credit rating, the cost of borrowing was less than it would normally be and the number of investors willing to buy such bonds was greater.

For the monolines, guaranteeing such bonds seemed risk-free, with average default rates running at a fraction of 1 per cent in 2003-2006. As a result, monolines leveraged their assets to build their books, and it was not being uncommon for a monoline to have insured risks 100 to 150 times the size of its capital base. Until recently, Ambac had capital of $5.7 billion against guarantees of $550 billion.

In 1998, the NY State Insurance Superintendent’s office, the only regulator of monolines, agreed to allow monolines to sell credit-default swaps (CDSs) on asset-backed securities such as mortgage backed securities. Separate shell companies would be established, through which CDSs could be issued to banks for mortgage backed securities.

The move into insuring securitized bonds was spectacularly lucrative for the monolines. MBIA’s premiums rose from $235m in 1998 to $998m in 2007. Year on year premiums last year increased 140%. Then along came the US sub-prime mortgage crisis, and the music stopped dead for the monolines, dead.

As the mortgages within bonds from the banks defaulted – sub-prime mortgages written in 2006 were already defaulting at a rate of 20 per cent by January 2008—the monolines were forced to step in and cover the payments.

On February 3, MBIA revealed $3.5 billion in writedowns and other charges in three months alone, leading to a quarterly loss of $2.3 billion. That was likely just the tip of a very cold iceberg. Insurance analyst Donald Light remarked, “The answer is no one knows,” when asked what the potential downside loss was. “I don’t think we will know to perhaps the third or fourth quarter of 2008.”

Credit ratings agencies have begun downgrading the monolines, taking away their prized AAA ratings, which means a monoline could no longer write new business, and the bonds it guarantees no longer would hold a AAA rating.

To date, the only monoline to receive downgrades from two agencies – usually required for such a move to impact on a company – is FGIC, cut by both Fitch and S&P. Ambac, the second largest monoline, has been cut to AA by Fitch, with the other monolines on a variety of different potential warnings.

The rating agencies did "computer simulated stress tests" to decide if the monolines could "pay claims at a default level comparable to that of the Great Depression." How much could the monoline insurers handle in a real crisis? They claimed, "Our claims-paying resources available to back members' guarantees…totals more than $34 billion."

That $34 billion was a drop in what will rapidly over the course of 2008 appear to be a bottomless bucket. It was estimated that in the Asset Backed Securities market roughly one-third of all transactions were "wrapped" or insured by AAA monolines. Investors demanded surety wraps for volatile collateral or that without a long performance history.

According to the Securities Industry and Financial Markets Association, a US trade group, at the end of 2006 there was a total of some $3.6 trillion worth of Asset Backed Securities in the United States, including of home mortgages, prime and sub-prime, of home equity loans, credit cards, student loans, car loans, equipment leasing and the like. Fortunately not all $3.6 trillion of securitizations are likely to default, and not all at once. But the AGFI monoline insurers had insured $2.4 trillion of that mountain of asset backed securities over the past several years. Private analysts estimated by early February 2008 that the potential insurer payout risks, under optimistic assumptions, could exceed $200 billions. A taxpayer bailout of that scale in an election year would be an interesting voter sell.

Off the books

The entire securitization revolution allowed banks to move assets off their books into unregulated opaque vehicles. They sold the mortgages at a discount to underwriters such as Merrill Lynch, Bear Stearns, Citigroup, and similar financial securitizers. They then in turn sold the mortgage collateral to their own separate Special Investment Vehicle or SIV as they were known. The attraction of a stand-alone SIV was that they and their potential losses were theoretically at least, isolated from the main underwriting bank. Should things ever, God forbid, run amok with the various Asset Backed Securities held by the SIV, only the SIV would suffer, not Citigroup or Merrill Lynch.

The dubious revenue streams from sub-prime mortgages and similar low quality loans, once bundled into the new Collateralized Mortgage Obligations or similar securities, then often got an injection of Monoline insurance, a kind of financial Viagra for junk quality mortgages such as the NINA (No Income, No Assets) or "Liars' Loans," or so-called stated-income loans, that were commonplace during the colossal Greenspan Real Estate economy up until July 2007.

According to the Mortgage Brokers' Association for Responsible Lending, a consumer protection group, by 2006 Liars' Loans were a staggering 62% of all USA mortgage originations. In one independent sampling audit of stated-income mortgage loans in Virginia in 2006, the auditors found, based on IRS records that almost 60% of the stated-income loans were exaggerated by more than 50%. Those stated-income chickens are now coming home to roost or far worse. The default rates on those Liars' Loans, which is now sweeping across the entire US real estate market, makes the waste problems of Tyson Foods factory chicken farms look like a wonderland.

None of that would have been possible without securitization, without the full backing of the Greenspan Fed, without the repeal of Glass-Steagall, without monoline insurance, without the collusion of the major rating agencies, and the selling on of that risk by the mortgage-originating banks to underwriters who bundled them, rated and insured them as all AAA.

In fact the Greenspan New Finance revolution literally opened the floodgates to fraud on every level from home mortgage brokers to lending agencies to Wall Street and London securitization banks to the credit rating agencies. Leaving oversight of the new securitized assets, hundreds of billions of dollars worth of them, to private "self-regulation" between issuing banks like Bear Stearns, Merrill Lynch or Citigroup and their rating agencies, was tantamount to pouring water on a drowning man. In Part V we discuss the consequences of the grand design in New Finance.

F. William Engdahl *is the author of* ***A Century of War: Anglo-American Oil Politics and the New World Order*** *(Pluto Press) and* ***Seeds of Destruction: The Hidden Agenda of Genetic Manipulation****, www.globalresearch.ca.*

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Seeds of Destruction

F. William Engdahl is a leading analyst of the New World Order, author of the best-selling book on oil and geopolitics, A Century of War: Anglo-American Politics and the New World Order,' *His writings have been translated into more than a dozen languages.*

Reviews of Engdahl's *Seeds of Destruction*

> What is so frightening about Engdahl's vision of the world is that it is so real. Although our civilization has been built on humanistic ideals, in this new age of "free markets", everything– science, commerce, agriculture and even seeds– have become weapons in the hands of a few global corporation barons and their political fellow travelers. To achieve world domination, they no longer rely on bayonet-wielding soldiers. All they need is to control food production. (Dr. Arpad Pusztai, biochemist, formerly of the Rowett Research Institute Institute, Scotland)

If you want to learn about the socio-political agenda –why biotech corporations insist on spreading GMO seeds around the World– you should read this carefully researched book. You will learn how these corporations want to achieve control over all mankind, and why we must resist… (Marijan Jost, Professor of Genetics, Krizevci, Croatia)

The book reads like a murder mystery of an incredible dimension, in which four giant Anglo-American agribusiness conglomerates have no hesitation to use GMO to gain control over our very means of subsistence… (Anton Moser, Professor of Biotechnology, Graz, Austria).

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